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FM AMCONSUL FRANKFURT
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INFO RUEATRS/DEPT OF TREASURY WASHDC IMMEDIATE
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RUCNFRG/FRG COLLECTIVE IMMEDIATE

UNCLAS SECTION 01 OF 02 FRANKFURT 001581

DEPARTMENT FOR EUR/AGS
TREASURY FOR LUKAS KOHLER/OFFICE FOR EUROPE AND EURASIA

SIPDIS

E.O. 12958: N/A
TAGS: EFIN ECON EU GM

SUBJECT: German Banks See Light at End of Subprime Tunnel, but Few Mergers Ahead

Ref: Berlin 0469, Berlin 0112, Frankfurt 1001

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¶1. Summary: Following first quarter reports showing further write-downs, major German banks are beginning to see signs of recovery in the financial sector, as the real economy exceeds expectations in both growth and employment. Industry insiders see challenges ahead in finding new, profitable business models, but find little cause for worry about the soundness of Germany's banking structure even though profits are down sharply. If the industry recovers and profits return, calls for further mergers in the state banking sector or for the state to privatize Postbank may diminish.

Banking Industry Resilient through Turmoil

¶2. First quarter 2008 earning reports revealed losses in most major German banks, reflecting ongoing turmoil in the financial sector. Deutsche Bank reported its first negative quarter in five years, with a write-down of 2.7 billion euros ($4.19 billion), while rival Commerzbank announced a write-down of 1.4 billion euros ($2.17 billion). Dresdner Bank, a subsidiary of Allianz, appears to be in worse shape, with losses of 0.9 billion euros ($1.4 billion), as rumors circulate that it will be broken up and sold off. In the state banking sector, where quarterly reporting is voluntary, the greatest write-downs were announced by BayernLB (2.0 billion euros or $3.1 billion) with smaller ones also reported by Landesbank Baden-Wuerttemberg (LBBW), Helaba, NordLB and HSH Nordbank. Financial authorities also froze assets of Weserbank as it approached insolvency, while a group of banks bailed out Duesseldorfer Hypothekenbank, which faced a liquidity crunch.

¶3. Despite the bad news, financial experts see signs that the worst is over. A senior economist at Deutsche Bank told Econ Off that high corporate profitability, good employment data and better than expected growth in Germany all point to the relative health of the real economy. Meanwhile, Deutsche Bank's business model remains sound, with strong returns in equity issuances and asset management in Asia. A Commerzbank executive also saw reason for optimism, saying that his bank saw an opportunity to invest in distressed assets where others were afraid to act. He did, however, admit that Germany's small- and middle-sized enterprises had been slow to adjust to the higher price of capital and were still reluctant to resume normal levels of borrowing. The write-downs of the last year also mean that expected profits were greatly diminished, which has altered banks' planning.

¶4. Some state banks such as Helaba and LBBW saw the recent turmoil as a vindication of Germany's dispersed financial sector and their business model. A senior LBBW executive told Frankfurt Consul General that his bank was less affected by the turmoil since it is structured like a universal bank and has steady retail income.

Executives at Helaba told Econ Off that their business model, which is focused on conservative retail and wholesale banking, has only suffered losses because of changes in spreads in lending markets. Several sources argued that heavy losses at WestLB, BayernLB and Weserbank were due to flawed strategies, which focused on riskier capital markets, and not systemic weaknesses. Meanwhile, the relative success of traditional retail banking among the savings banks and banks like Helaba has only served to confirm the viability of traditional banking.

¶5. Most sources ascribed the slowdown in profits to a short-term readjustment in the financial sector and a downward overshooting in the accounting valuations of assets. While asset markets find their floor, volumes of leveraged buy-outs, corporate bond issuances, home-mortgage lending and other sources of traditional bank income are all down in the current cautious market. Meanwhile, lending spreads have increased, raising transaction costs for banks. The implementation of Basel II at the start of the year has also required banks to raise capital holdings, creating a need to hold capital.

Prospects for Mergers Low

¶6. Few experts saw reason to believe that Germany's dispersed financial system would consolidate further, especially if greater stability returns to the sector.
Sources at Deutsche Bank and Commerzbank expressed doubt that the government would privatize Germany's largest retail bank, Postbank, since that would result in many lost jobs. Although both banks might be interested in purchasing Postbank and benefiting from steady retail banking income, the Commerzbank executive said his

bank saw better opportunities elsewhere (his bank was currently conducting due diligences on two eastern European banks). Representatives of both banks agreed that Allianz would be foolish to break up and sell off pieces, if not all, of troubled Dresdner Bank at a time when its price would be at an all-time low. However, both Deutsche Bank and Commerzbank are allegedly stock-piling cash for mergers, either at home or abroad.

¶7. Despite LBBW's successful acquisition of SachsenLB, executives in the state bank sector see little reason to believe that there will be more consolidation. Referring to rumors that LBBW would acquire WestLB or BayernLB, the senior LBBW executive told Frankfurt Consul General that state banks should merge only if they are profit-making enterprises. Executives at Helaba told Econ Off that both the savings banks (who partially own the state banks) and the federal Ministry of Finance would push for more consolidation among state banks, but this would continue to be opposed by state-level minister presidents intent on protecting local interests. They did, however, express some confidence that LBBW would take over BayernLB in the next twelve to eighteen months.

¶8. Comment. Despite a bad first quarter, German bankers remain optimistic that the worst of the subprime turmoil is behind them and blame bad business models in certain banks as well as an adjustment to new conditions for most of the trouble. If economic fundamentals such as employment and growth remain strong in Germany, there is reason to believe that an overall downturn will be avoided and the financial sector will rebound. However, the turmoil has resulted in lower than expected real profits for banks and forced many institutions to change plans and strategies. If the sector does bounce back, pressure to consolidate may also diminish even though many experts feel the industry has too many players. End Comment.

¶9. This cable was coordinated with Embassy Berlin.
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